HOGAN & HARTSON L.L.P.

MEMORANDUM FOR
THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

Washington Monthly Report

Congress returned from its August recess to face the daunting task of enacting into law the remaining 12 of the 13 appropriations bills that are necessary to keep the Federal government operating in the new fiscal year that begins October 1. The task of enacting these appropriations bills is likely to be the principal focus of Congress over the next 3 to 4 weeks.

At this point, Congressional GOP leaders have indicated a desire to complete these spending measures without dipping into the Social Security trust fund surplus and then simply get out of town for the year. The prospects for enacting any significant tax legislation have dimmed greatly, as the GOP leadership is particularly wary of being drawn into a year-end summit negotiation with the President in which they fear being forced to accept greater domestic spending for Administration programs as the *quid pro quo* for their desired tax relief.

Moreover, just getting the 13 appropriations bills through is likely to be a contentious exercise, with some GOP leadership sources predicting that Congress will remain in session until Thanksgiving. Indeed, when recently asked by reporters what sort of catalyst would be necessary for Congress to resolve all of these contentious appropriations issues, Senate Republican Conference Chairman Larry Craig (R-Idaho) replied, "The aroma of turkey."

Mandatory Social Security

The legislative effort to pursue substantive Social Security reform appears over for this Congressional session. Congress will have its hands full passing spending bills. There is little stomach for taking on another controversial issue like Social Security reform at this late juncture in the Congressional session.

There continues to be the possibility that gridlock between Congress and the President over the spending bills will force the convening of some form of budget summit. However, it remains unlikely that substantive Social Security reform will be part of that mix, beyond the possibility of walling off the surplus in the Social Security trust fund and leaving substantive reform for next year or the next Congress.

The good news is that the State and local government employers and employees who are outside of the Social Security system finish the year in a much stronger position than at the outset. The efforts of the various State and local government groups, including the strong grassroots efforts from STRS employers and employees and their organizations, have paid off. No longer is sweeping in the remaining 7 non-covered States and the other scattered non-covered employers seen as just "free money" for the Social Security system. The substantive case has now been driven home that the imposition of mandatory Social Security coverage will have a harsh adverse cost impact on State and local governments and the varied services they provide to the public. We also have made a substantial dent in the so-called "fairness" argument – about the supposed "unfairness" of excluding these State and local employees from Social Security, while everyone else must contribute. Further, the grassroots message from home finally has gotten through to a new generation of Members of Congress, who now recognize the political sensitivity of the issue. Finally, Rep. Rob Portman (R-Ohio) and Rep. Bob Matsui (D-Calif.), two respected and influential Members of the House Ways and Means Committee that has jurisdiction over Social Security, have now taken the legislative lead in the effort to fend off any proposals for mandatory coverage of State and local employees.

While the threat of mandatory Social Security has faded into the background for the year, it still must be taken seriously. Next year will be a Presidential elections year as well as a key election battle for party control of the House of Representatives. The easy answer would be to say that a controversial item like Social Security reform will not rear its head as both parties try to avoid alienating voters. However, President Clinton in the last year of his last term may continue to try to build his legacy for the history books and could resurrect the issue next year. For their part, Congressional Republicans may feel pressure to reassure aging Baby Boomers that Social Security will be there and solvent when they need it.

Accordingly, grassroots efforts should continue and seize upon any opportunity to buttonhole the local Member of Congress when he or she is back home in the district, as well as any Presidential contender who may be passing through. We will continue to be vigilant at this end.

Elk Hills Compensation

The $36 million Elk Hills compensation payment due for FY 2000 will be part of the impending appropriations crunch.

The Senate is expected to pass shortly its version of the Interior Appropriations legislation. A House-Senate Conference Committee then would be necessary to meld the House Interior Appropriations bill – which includes the $36 million Elk Hills appropriation – and the Senate Interior Appropriations bill, which does not.

We have been actively working on the White House directly on a number of fronts – the Political Affairs Office, the Intergovernmental Affairs Office, and the Vice President's Office. In addition, the Governor's Office in Washington has been quite responsive. The Governor has included Elk Hills as a priority item on his list of appropriations requests to be submitted to the President through the President's Director of Intergovernmental Affairs at a White House meeting to be held shortly. In response to our efforts, Secretary of Energy Richardson has committed to sending a strong letter of support just on Elk Hills to the House and Senate Conferees once the Interior Appropriations bill is ready to go to Conference.

On the Hill, we are continuing to work with our lead sponsors, Rep. Bill Thomas (R-Bakersfield) on the House side and Senator Feinstein on the Senate side.

We are continuing to coordinate with CRTA on the grassroots campaign, now focused principally on the Administration.

SEC Pay-to-Play Proposed Regulations

There has been a variety of reactions by the national organizations of State and local government groups to the proposed "pay to play" rules issued last month by the Securities and Exchange Commission. These proposed SEC rules would sharply curtail campaign contributions by investment advisors to State and local government officials affiliated with public pension plans. (We provided an advance copy of the proposed rules to the Board in conjunction with the August Board meeting and summarized the proposed rules in our August 9 Monthly Report. STRS Chief Counsel has provided a more detailed analysis to the Board.)

We understand that the Council of Institutional Investors has endorsed the proposed rules. Some national groups reportedly will take no position on the proposed rules. Still other national groups have expressed concerns, such as the National Association of State Treasurers and the Government Finance Officers Association (GFOA). We understand that GFOA takes the view that this matter would be better handled by State regulation, but that if the SEC is going to move forward with the rules a number of changes should be made. We understand that GFOA will be suggesting that the proposed *de minimis* threshold of $250 for campaign contributions be raised to $1,000; that the category of covered elected officials be limited to those who have a direct relationship with the plan such as service on the plan's board, rather than extending all the way up to the Governor simply because he or she has appointive authority regarding pension board members; that the category of persons whose contributions are attributed to the investment advisor be more narrowly defined; and that the definition of campaign contribution, particularly the category of covered in-kind contributions, be clarified.

We will continue to monitor developments on this front and keep the Board apprised.

Pension Provisions of Tax Cut Legislation

The massive tax cut package adopted by Congress and about to be vetoed by the President would have made the furthest-reaching changes in years to the pension tax rule. These broad changes were outlined in our August Monthly Report.

Public plans did quite well with a series of provisions to enhance portability among public plans and to ease various limits and restrictions under current law. These public plan provisions are largely noncontroversial and are not costly and would be expected to be included in any subsequent tax legislation that is broad enough to include pension tax changes.

At this juncture, it appears a long shot that anything more than a very narrow tax bill extending a series of expiring tax incentive provisions will be enacted by Congress this year. As described above, the Republican Leadership in Congress is very wary of being drawn into any "global" budget negotiation with the President in which they would be forced to accept higher domestic spending as the price for tax relief legislation (of much smaller scope than the $792 billion, 10-year cut adopted by Congress and vetoed by the President). Accordingly, these public plan pension portability changes may have to await the consideration of broader tax legislation next year.

Controversy Over Conversion of Traditional Defined Benefit Plans into Cash Balance Plans

There is a growing controversy over the recent trend among private employers of converting the traditional defined benefit retirement plan into a cash balance plan. The high-profile conversion by IBM and the fierce resistance by long-time IBM employees has thrust this controversy into the public spotlight, resulting in the introduction of legislation to alleviate the impact of such conversions, a hearing into the matter by the Senate Committee on Health, Education, Labor, and Pensions, and the formation of a special task force by the Equal Employment Opportunity Commission to study possible age discrimination effects.

While this controversy over conversion of traditional defined benefit plans into cash balance plans in the private sector has no direct bearing on STRS, in light of the existence of STRS Cash Balance Program it bears some watching regarding the issues discussed, if only to avoid any misunderstanding that this whole controversy somehow has an impact on STRS and its participants.

Traditional defined benefit plans, like the main STRS defined benefit plan, provide a retirement benefit determined on the basis of years of service and the worker's highest level of compensation. The benefit accrues under this traditional plan in a back-loaded fashion, with a significant portion of the benefit accruing in the last 5 to 10 years of service as the participant's compensation grows and in effect increses the value of each year of service.

By contrast, cash balance plans -- which also constitute defined benefit plans because they provide a guaranteed benefit – operate more like defined contribution plans, with the annual contribution of a specified percentage of the participant's compensation to a hypothetical account on which interest is credited at a specified rate. Upon retirement, the participant is entitled simply to the balance in his or her hypothetical account. As you know, STRS administers the Cash Balance program for part-time educators.

Employers point to the advantages of the cash balance plan's steadier accrual rate and portability for a younger, more mobile workforce, as well as pesnion cost savings for the employer. However, older workers with significant periods of service under the traditional plan can suffer substantial harm from the conversion from the traditional plan to the cash balance plan.

The potential harm to older, longer service workers can take two forms. First, upon the conversion the worker generally is entitled to the greater of (i) his or her accrued benefit level under the traditional plan as of the time of conversion, or (ii) the benefit as calculated under the new cash balance formula. In the case of an older worker with significant service, it may take years for the benefit under the new cash balance formula to surpass his or her accrued level of benefit under the old plan at the time of the conversion. During this period, the worker effectively accrues no retirement benefit for additional service rendered until the new formula catches up. Second, employers have some flexibility in the assumptions used to convert the value of the participant's benefit under the traditional plan into an opening balance under the new cash balance plan, with the result that in some conversions the opening balance under the new plan is lower, and sometimes significantly so, than the actuarially-determined benefit under the old plan.

Sen. Tom Harkin (D-Iowa) has introduced S. 1300 to alleviate the effects of such conversions on participants. Sen. Harkin's proposal would require that participants who are converted immediately begin accruing a benefit under the new cash balance plan for service after the conversion, as well as being entitled to the value of their accrued benefit under the old plan. Sen. Harkin's measure would amend the tax rules under section 411 of the Internal Revenue Code, rules from which governmental plans are exempt altogether. On another front, the omnibus tax bill about to be vetoed by President Clinton included a provision similarly addressed at the recent spate of cash balance plan conversions, but which took the somewhat different tack of requiring notice and disclosure to participants in cases of benefit reductions. (This provision excluded governmental plans from its reach).

On September 21, the Senate Committee on Health, Education, Labor, and Pensions held a hearing on the issues surrounding the cash balance plan conversion. Witnesses from Treasury and the I.R.S. expressed concern about the impact of these conversions and promised to examine the matter further.

Potential age discrimination issues are raised as well by the conversions, especially since older workers may work for some period of time following the conversion without accruing retirement benefits for their additional service, while their younger counterparts steadily accrue benefits for the same period of service. The Equal Employment Opportunity Commission has formed a special task force to look into these age discrimination issues.

John S. Stanton

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